"Predatory" and "Lending"

by
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(Note: This article was written for a national mortgage industry publication by Chuck Cross in his capacity as a freelance writer. Chuck is also a supervising analyst with the Washington Department of Financial Institutions. He oversees enforcement against mortgage brokers, consumer loan companies, escrow agents and officers, as well as check cashers and sellers (payday lenders). The article offers some valuable insights and advice. Some of the discussion may be a bit technical for the inexperienced borrower, but we feel that the information may be helpful.)

Likely, the two most tiresome words for the mortgage industry over the last year have been "predatory" and “lending." Compounding your frustration is that you have been saddled with a term that is not connected with any definitive meaning. And no, I'm not going to attempt to define it here. In fact, as a regulator, I don’t even like the term, which appears to be a merging of two separate issues: Mortgage Fraud and High Cost Loans.

Tom Estes, in his article "Defining & Controlling Predatory Lending" (National Mortgage Broker, September 2000), did an excellent job of raising the question: "What is predatory lending?" and parsing out the three main camps on the issue. The first camp draws a bright line between conventional loans and sub-prime or "predatory" loans. The second camp believes that thresholds for rates and fees define the breaking point at which predatory lending occurs. The third camp believes that mortgage fraud practiced against the consumer is predatory lending. In other words, practice -- not product -- controls the terminology.

I am firmly in camp three and have been there for some time. If you talk to me about the subject you will most often hear me use the phrase, "Mortgage Fraud against consumers." You may also hear me refer loosely (or directly if I'm addressing HOEPA issues) to high cost loans. But unless I am referring to someone else's position you won’t find me merging the two as if they are the same event. One is a practice. The other is a product. Although we are identifying a greater degree of mortgage fraud within the high cost or sub-prime lending industry, mortgage fraud is not a characteristic of that industry. Mortgage fraud, like any fraud, simply follows money. So naturally we expect to see more of it where the rates and fees offer a greater reward for the risk.

Of course it is easier to identify product than practice. And I am sure that many would argue that if the product attracts a criminal element the most efficient form of eradication is to remove the product, or at the very least, hang a big warning sign around its neck like we did with tobacco and alcohol. But then did that really work with tobacco and alcohol problems? Have HOEPA disclosures produced any tangible benefit?

Even if high cost loans were eliminated, mortgage fraud would survive and thrive. It was going on before sub-prime loans were an everyday product and it exists to a significant degree today in the conventional markets. Some might think that removing the profit potential from the industry would dramatically reduce the occurrence of fraud. But it would also dramatically reduce our access to credit, driving loans into the black market and re-attracting a more ruthless element of fraud.

Prior to the Fed's September hearing on predatory lending, the director of our agency asked me what the answer to the problem was. I told him that I believed in a two-pronged approach to the problem: Simplification and Enforcement. Of the two, simplification should have the greatest deterrent effect, with enforcement used to round up those who will gravitate to crime no matter the cost. So let's take a look at simplification in the mortgage process.

Those wishing to commit mortgage fraud against consumers operate by making complex events simple and simple events complex. The result is confusion, and confusion allows the all-important sleight-of-hand to take place. Magicians and other masters of illusion use this technique. Take the thimble and pea game of "thimblerig," for example. The spectator is drawn to gamble by the simplicity of the game and the one in three odds. The swindler may even let the spectator win one or two rounds to build confidence and up the gamble. But in the last round, the swindler not only palms the pea so there is no chance of winning, but increases the speed and complexity of the rotating thimbles such that the victims are completely confused as to where the pea should be, and are therefore unaware that they have been swindled by the sleight-of-hand.

In mortgage fraud against the consumer, the most common swindle is known as bait and switch. This is the "set- up," or bait, of one desirable lower-cost product, with the sleight-of-hand switch to another, less-desirable, higher cost product. We commonly see this swindle take place in six areas: loan type, loan amount, loan rate, loan costs, loan payment and prepayment penalty. And although the actual switch occurs at or near closing, the set-up occurs at or near origination when clear disclosure is required.

So how is it that the requirement of clear and early disclosure can be converted to a tool of deception? By confusion. While intended to be simple the disclosures are reasonably complex. Government has unwittingly created the confusion the bait and switch artist needs to swindle the consumer. Lines of numbers each requiring a section of regulation to explain and calculations the results of which not only confuse borrowers and lenders, but regulators as well, create a morass of uncertainty that is the playground of fraud. Let's take a quick look at how the Good Faith Estimate (GFE) and the Truth in Lending Disclosure Statement (TIL) enable and foster confusion in the solicitation of a mortgage loan:

Loan Type: The classic bait is a fixed rate. The switch is an ARM. The GFE has no requirement that the loan type be given. The TIL requires a best case scenario of a changing stream of payments and a checked box referring to a variable rate feature. Not much disclosure in the hands of a fast-talking loan officer. And even if a fixed rate is disclosed initially, re-disclosure may not be required until signing. And then it's too late.

Loan Amount: Neither the GFE nor the TIL require that the loan amount be disclosed. The TIL requires the disclosure of the Amount Financed; a term that means nothing to the borrower, but can be effectively used to leave the impression of a lower loan amount.

Loan Rate: Again, neither document requires disclosure of this major element of the loan. Instead, the APR, another nearly meaningless term is disclosed, and with it comes more confusion.

Loan Costs: The most clearly disclosed part of the transaction yet still wrought with confusion and ambiguity. The borrow- er is faced with a myriad of divisible costs carried under terminology intended to hide the fact that many are simply "junk' fees. Washington State is the only jurisdiction that prohibits increases in initially disclosed fees making this part of the transaction ripe for bait and switch practices in most parts of the country.

Loan Payment: The TIL requires disclosure of the principal, interest and mortgage insurance part of the payment only. A popular deception is to leave the borrower with the impression that this lower payment amount is inclusive of monthly escrow amounts for taxes and hazard insurance.

Prepayment Penalty: A small box in the middle of the IIL must be checked. It is easily overlooked or covered up during the disclosure process. Further, this section may be rnis-marked at initial disclosure provided that it is accurate by the final TIL.

The disclosure requirements under RESPA and Truth in Lending have remained relatively unchanged for over 25 years. Although attempts have been made by the governing agencies to provide greater clarification to lenders and borrowers, the result has been greater complexity and more confusion. The fact is, bureaucracies do not operate from platforms of simplicity. They are often formed in complexity and are layered with more complexities over time. Their products (e.g., regulation and interpretation) are formulated in much the same way so that all simplicity is lost early in the process and we are left with requirements that are so layered with confusion that not even the primary regulator is sure of the meaning. I have been waiting so many months for simple answers from both HUD and the Federal Reserve that I have since forgotten what my questions were.

So how does simplification of the disclosure process help to eliminate fraud?

1. Fraud cannot stand the light of day. Simple disclosure exposes the transaction for all to see. Mortgage fraud needs the cover of confusion in order to survive. There is only one explanation for not making things as clear as possible for the borrower. A desire to hide the truth and profit from deception.
2. Simple disclosures foster understanding. Understanding translates into an informed borrower. An informed borrower is far less Rely to fall victim to fraud. An informed borrower will challenge the process and hold the originator to the agreement, or walk on the transaction.

Simplicity does an excellent service to the non-fraudulent majority of the industry as well. It creates a safer environment for business transactions and lowers the cost of compliance and regulation. But do not expect the idea of simplicity to be welcomed by all. An entire sub-industry on both sides of the fence makes an honest living from the very intricacies and complexities that have helped lead us to many of the problems in the mortgage market today. Not only will some of us be reluctant to let go of what we know, but there will likely be a whole lot less for us to do. Imagine if you knew as much about regulation as me. What, then, would I have left to do? Enforcement, that's what! I could invest all of the funds you send my way in getting the bad element out of your industry rather than checking calculations on APRS.

After considering my two-pronged approach of Simplification and Enforcement, the Director (of DFI) asked me if it was possible to draft a disclosure form that would actually make the process simple. My response was that I could draft a one-page (short paper no less) disclosure that would eliminate the TIL and reduce the importance of the GFE while delivering more meaningful information to the consumer. No gimmicks, no complex calculations and no law degree required.

My concept is derived from what borrowers and loan officers have told me is important in the decision to accept a loan offer. It begins with an explanation of the purpose of the disclosure. Nex,t it gives the borrower the primary information required to assess the loan and a simple break out of costs. This section is followed by notes that identify rate lock, ARM adjustments, details of the payment, financing of costs and prepayment penalty. At the bottom the borrower is instructed and encouraged to compare terms from origination to closing (which is why I could not see my way yet to eliminating the GFE altogether).

We presented that disclosure to the Fed on September 7th of this year and I include it here for you now. It's not perfect and was only intended to be an example of what could be if we only stepped away from the regulations and truly thought like a consumer. As yet, we haven’t heard back from the Fed, but I'm interested in your thoughts and comments. Please drop me an e-mail.

READ THIS FORM CAREFULLY IN ITS ENTIRETY

PROPOSED TERMS AND COSTS OF YOUR MORTGAGE LOAN

This disclosure is provided in addition to specific disclosures that may be required under federal and state law. The intent of this disclosure is to provide you with a simple, clear explanation of your proposed loan terms and costs. Additionally, by following the steps outlined at the bottom of this document, you may compare the proposed terms to the final terms at closing.

LOAN AMOUNT	LOAN TYPE	RATE	PAYMENT
$100,000.00	30 YR ADJUSTABLE RATE	7% SEE NOTICE 1 BELOW	$925.30 SEE NOTICE 2 BELOW

THE FOLLOWING COSTS ARE PROPOSED ON THIS LOAN

TOTAL FEES TO LOAN ORIGINATION COMPANY	$ 2,500.00
TOTAL FEES TO LENDER FUNDING LOAN	$ 1,300.00
TOTAL FEES TO ALL OTHER SERVICE PROVIDERS	$ 1,800.00
TOTAL FEES YOU WILL INCUR	**$ 5,600.00**

THE FOLLOWING TERMS APPLY TO YOUR LOAN

YOUR RATE IS LOCKED NOT LOCKED . IF YOUR RATE IS LOCKED, YOU HAVE A RIGHT TO KNOW THE TERMS OF THAT LOCK. YOUR RATE MAY ADJUST UPWARDS BY 1.0 % EVERY 12 MONTHS UNTIL IT REACHES 13.0 % THIS RATE ADJUSTMENT MAY OCCUR REGARDLESS OF ANY OTHER FACTORS.

THE PAYMENT INCLUDES $ 260.00 OF TAXES INSURANCE MTG INS. OTHER. YOUR CONTRACTUAL (NOTE) PAYMENT EQUALS $ 665.30 .

$ 0 OF THE ABOVE COSTS ARE INCLUDED IN YOUR LOAN AMOUNT. $ All OF THE ABOVE COSTS WILL BE PAID BY YOU AT CLOSING.

YOUR LOAN DOES DOES NOT CONTAIN A PREPAYMENT PENALTY. THE TERMS OF THIS PENALTY ARE WRITTEN IN YOUR NOTE. THIS PENALTY MAY BE SIGNIFICANT AND MUST BE PAID BY YOU IN THE EVENT YOU REFINANCE THE LOAN OR MAKE SIGNIFICANT ADDITIONAL PAYMENTS TO PRINCIPAL.

PROPOSED TERMS VERSUS FINAL TERMS

The terms provided to you in this disclosure are estimates. However, if any of these estimates increase, for any reason prior to the signing of closing papers, the below named company will provide you with revised proposed terms that match your closing terms at least three days before the date of signing closing papers.

HOW TO COMPARE

The Loan Amount, Loan Type, Rate, Rate Adjustment, and Note Payment should be compared to the Note you sign at closing. The costs identified above are derived from a disclosure form known as a Good Faith Estimate. You should compare the costs on this form to the Good Faith Estimate before signing either disclosure. You should compare the costs on this disclosure, or a revised version of this disclosure, to the HUD Settlement Statement you will receive at closing.

This disclosure was delivered by ______________________ (Representative) of ______________________

(Company), on ______________ (Date). ______________________ Borrower Date ______________________ Borrower Date

FOR YOUR OWN PROTECTION DO NOT DATE THIS FORM ANY OTHER DATE THAN THE DATE ACTUALLY RECEIVED BY YOU. DO NOT LEAVE THE DATE SECTION BLANK. prepared by Chuck Cross, WA DFI 8/00